Deregulation as a Political Process

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I. Deregulation is a shorthand term for reforms that include not just the loosening or withdrawal of government regulatory controls over business behavior, but the liberalization of market entry and, in most nations, the privatization of state assets, as well. It is one of the major political-economic phenomena of recent decades, and is both manifestation of, and basis for, the so-called globalization of the economy.

The deregulation of telecommunications is particularly important in globalization. This is because it facilitates the integration of communications infrastructures across nations, thus helping expand the scope of the international finance system to encompass the world in real time and permitting the spatial and functional dispersal of the business enterprise into flexible networks of firms which seize the opportunity of the most advantageous conditions for profit-making everywhere.

II. But if the deregulation of telecommunications has global economic consequences it usually has more local political explanations. This may be especially true of the United States, the place the deregulation movement began. It's important to see deregulation in the USA as a general <u>political</u> phenomenon, not confined to communications and not the particular consequence, either of the technological revolution in communications or of some abstract notion of economic necessity. Deregulation in the United States affected particular kinds of industries under particular kinds of regulatory controls: infrastructure industries, such as airlines, trucking, telecommunications, broadcasting, banking, natural gas, electricity, all of which had been under what we call price-and-entry regulation, where government determined the number of firms to provide service and set the prices the regulated firms could charge consumers for the services rendered.

The price-and-entry regulatory regime brought many infrastructure industries under regulatory controls during the Great Depression, when too much competition was believed to undermine these industries. Regulation secured stability and infrastructure growth. It typically created a system of cross-subsidies that supported the expansion of service to otherwise unremunerative areas and customers. In telecommunications, the system facilitated universal service. A central feature of regulated monopolies is that they came to function as a kind of social democratic industrial policy. This might be understood generally as consonant with Keynesian macroeconomics and the social contract between labor and capital that underlay them. The regulatory regime created a series of quids pro quo: government awarded a company an exclusive franchise and guaranteed a fair rate of return, or profit. In exchange, the company took on an obligation to serve all who requested service and generally to keep basic tariffs low. In practice the arrangement also meant the broad unionization of labor in those industries. Price-and entry regulation thus represented a political coalition, albeit often unrecognized, between monopoly providers, small users, organized labor, and the state to spread fixed costs across many participants.

But, of course, there are problems with any political-economic regime. The telephone example is typical. Under rate-of-return regulation, there is no clear relation between costs and prices. Prices are set according to general goals in a process of quasi-political accommodation between service providers and regulators. Costs for any particular service within the regulated system are largely irrelevant, because they are internal to what was an integrated system. But the incentive of the firm under rate-of-return regulation is to inflate its rate base by overbuilding its plant or by increasing equipment stocks and fixed capital more than would be the case under the normal cost-minimizing pressures of the market -- a practice sometimes called "goldplating" and known in the economics literature as the Averch-Johnson effect. Indeed, there were longstanding allegations that, in addition to common goldplating, AT&T used its Western Electric equipment subsidiary to artificially boost the prices of equipment to the Bell operating companies. This would further inflate the rate base from which the rate of return was determined. The allegation was strong enough that the government looked into it three times since the 1930s.

Another problem that beset regulated telephony was that, notwithstanding exceptional performance generally, AT&T could not keep up with demand, particularly the demand from large business users who wanted private lines for their geographically dispersed factories and offices in the period of economic growth following the Second World War. AT&T's lack of capacity persuaded the Federal Communications Commission to permit the limited and provisional entry of providers of specialized services and certain customer premises equipment. These limited liberalization moves were <u>not</u> done in support of competition per se; they were undertaken because of AT&T's temporary incapacity. But however small and limited were these new entrants, among which was MCI, they had secured a niche at the fringes of the Bell monopoly. And with technology and a big legal effort, and a quiet alliance with some large users, they began to try to move from the fringes toward the Bell core.

III. The success of price-and-entry regulation was dialectically the reason for its downfall. Regulation helped expand infrastructure networks universally. But once the infrastructure network was constructed and in place, the conditions and rationales supporting monopoly became less salient. Competition over the network was possible, but was generally thwarted by the monopolist and the regulator who, together, argued that the system would suffer technically and economically if new entrants were permitted. The cross-subsidy burden, which tended to fall more heavily on large users, was perceived as increasingly onerous -- especially when service options to large users were limited and those users were usually prevented from taking advantage of options outside the regulated system. Politically, the guaranteed fair rate of return looked dubious -- especially during periods of inflation when the regulated monopolist asked for one rate hike after the other. Indeed, the relation between the regulator and the main regulated parties appeared too close, too cooperative.

I'm arguing that, while technology and economics are important material conditions, if you will, one must look at the broader contexts of American politics to fully understand the regulation question. On the one side, the tight regulated system I've just described came subject to criticism in the 1960s by liberals and a thriving public interest movement as evidence of the "capture" of regulatory agencies by the industries under regulation. Regulators and large regulated industries were thought to be in bed with eachother. The participatory politics of the 1960s affected regulation in important ways. It led to the creation of new, "social" regulatory agencies, such as the Environmental Protection Agency, the Occupational Safety and Health Administration, and the Equal Employment Opportunity Commission, with jurisdiction over new, trans-industry issues such as the environmental protection, worker safety, civil rights. It also opened up the old price-and-entry agencies to participation by parties that had been left out of the original arrangement. The liberalization of the legal doctrine of "standing," that is, who was permitted to bring actions in court and who could argue before regulatory agencies, was a crucial factor in the expansion of participation. In this respect there was a kind of alliance between the courts and the public interest movement in the 1960s. This democratization of regulation served in general to make the regulatory process, always political, a much more open and messy one. All parties used the regulatory and legal processes to impose costs on their opponents, including the cost of the time it would take to reach a final regulatory decision on any particular issue, known as the "regulatory lag." When combined with the inflationary spiral of the mid 1970s, the uncertainty and regulatory lag began to impose costs on industries under regulatory controls. In response to this, business engaged in a counterattack against regulation.

On another side were academic economists who had been criticizing the efficiency of regulated industries for several years. As early as the early 1960s some academic economists had conducted empirical studies of regulation in specific industries. They concluded that regulation was sometimes irrational, that monopolies thought to be "natural" were in fact maintained only through regulation, that regulation stifled innovation, and that regulation often was used as a means of cartel management. Finding special instances where the prices for the same service provided by regulated and unregulated providers could be compared, the studies found significant price differences. Free markets, these scholars concluded, were more efficient than regulated ones. Corporations under rate-of-return regulation were particularly prone to "goldplating." These economists had been criticizing regulation for years, but by the mid to late 1970s they found an audience in business, now suffering under the regulatory consequences of 1960s politics. Academic studies became part of business strategy to transform the political agenda on government regulation. Foundations were established and corporate largesse funded a large number of scholarly projects that were critical of regulation and that blamed it for high inflation and poor sectoral and national economic performance. More ideologically, regulation was said to compromise basic freedoms. This was the clarion call to "get the government off the backs of the people."

A central irony I describe in my book is that, while most of the corporate antagonism and rhetoric was directed against the new "social" regulatory agencies such as EPA, OSHA, and EEOC, it was in fact the traditional price-and-entry regulation of infrastructure industries that came to be deregulated. This was because these agencies and these regulated industries had earned the wrath of <u>both</u> liberals and conservatives. Each wing of a curious, heterodox political alliance of liberals and conservatives, of public interest movement leftists and free market ideologues, operating wholly within their own internal ideological logics of participatory democracy and free market economics respectively, believed that the reform of price-and-entry regulation was in the public interest. But the alliance did <u>not</u> extend to the reform of the social regulatory agencies. And while the key firms and unions in the regulated industries fought against reform, deregulation was pushed strongly by the powerful large users of such services. As Congress began holding hearings and threatening to pass deregulation legislation, some regulatory agencies began experimenting with reform on their own.

These early deregulatory experiments began with the opening of access to networks. Under this approach, the physical infrastructures of the networks (such as airports, cables, pipes) remained regulated natural monopolies. Access to these networks was opened such that the remaining elements could be submitted to competition -- such as airline traffic, value-added telecommunication services, gas and electricity production. Telecommunications, as I've mentioned, experienced its share of limited entry liberalizations early. When those specialized service entrants attempted to gain access to the public service telephone network, they were rebuffed by AT&T. AT&T's use of the network as a bottleneck to competition was the factor that led to the Justice Department's lawsuit against AT&T in 1974.

Congress passed various pieces of deregulation legislation beginning with commercial airlines in 1978. The heterodox coalition of liberals and conservatives responsible for deregulation was there in the effort to reform telecommunications. But legislation was stymied. The issues in telecommunications were so complex, the stakes so high, and AT&T's lobbying power so sufficient, that, unlike deregulation in other areas, legislation to deregulate telecommunications could not get through Congress. Until the Telecommunications Act of 1996, communications deregulation was achieved less through legislation than through reform directed by the Federal Communications Commission and, especially, by the 1982 Consent Decree that compelled the divestiture of AT&T.

IV. Across all the affected industries, deregulation initiated a flood of new entrants. This disrupted business-as-usual and set off price-wars, business failures and consolidations, along with significant labor retrenchment. On a political level, deregulation broke up the old Keynesian-inspired coalition of monopoly providers, small users, organized labor, and the state. More than just the liberalization of entry for service suppliers, the new deregulated arrangement represented the liberalization of exit of (primarily large) users from a sharing coalition that had become confining. The effect of this can be seen on labor and small users. Competition created new start-up companies, almost all non-union. It also induced existing companies to reduce their work forces and reduce wages; unionized providers moved to establish non-union subsidiary companies or dual-labor contracts -- all very much in keeping with the emerging pattern of flexible capitalist organization described by many theorists as "post-Fordist." While competition offered consumers an increased variety of price/quality options, prices for individual services were realigned more closely with marginal costs, resulting in substantial price reductions in high-traffic areas or routes, and equally substantial price hikes in low-traffic ones. In telephony for example, tariffs for long-distance fell by about 40 percent; tariffs for local service rose about 50 percent.

But this was not the end of regulation, by any means. Indeed, facilitating a transition from a regulated order to a competitive one requires perhaps more regulatory attention than ever. Making sure the incumbent provider does not use its market power to crush nascent competitors means that the new regime is not really market competition, rather it is a form of regulated, even "contrived," competition. And even this is not satisfactory. A key problem is that once the network is opened, you have the problem of the network provider being both a monopolist and a competitor. Policing that increasingly uncertain boundary proves so difficult that this problem alone becomes an impetus to increase the scope of competition.

This, I think, was in part the impetus behind the passage of the Telecommunications Act of 1996. Attempts to rewrite the 1934 Communications Act had been before Congress for well over 20 years, but were always thwarted by various industry groups unwilling to give up existing policy protections. US communications policy had evolved to keep communications services <u>separated</u>: broadcasters could not be carriers; telephone companies could not, by and large, own cable television systems, and so on. By the mid 1990s things had changed. Technological developments, particularly digitalization and compression, did finally augur the convergence of previously separated modes of communications that so many people had talked about for so many years. The break-up of AT&T hastened certain convergences. The old regulatory separations between content and conduit providers, between telephony and cable television, between local and long-distance telecommunications, between computers and telecommunications, finally seemed outmoded. Regulating these separations, especially as technology was effacing them, was increasingly difficult. And policy-makers within the Clinton administration saw national and international economic opportunities if the roadblocks in communications policy were removed -- this was the logic behind the rhetoric of the National Information Infrastructure (the "information superhighway") initiative.

More to the political point, perhaps, were the negotiations between major industry players. What would it take for the various big industry players to relinquish existing policy protections and face competition in their own turfs in order to expand into someone else's territory and invest in new areas? The shared assumption was that constructing competitive communications networks would be high-risk, capital intensive projects. It would require the resources of large and flexible corporations (whose needs and failures would also spur small businesses and entrepreneurs in budding and niche markets). Thus the compromises between major industry players which constituted the Telecommunications Act of 1996 redrew the policy map. The Act articulated a bold shift in the goals and mechanisms of policy and regulation. The broad change was that the public interest will be secured not by regulation but by competition. A key concept is regulatory "forbearance": regulation will be deployed only to the degree that it encourages a competitive telecommunications marketplace. The Act eliminates the legal basis for protected monopoly in telecommunications and encourages mergers and vertical integration as ways to facilitate what's termed "cross-platform" competition, that is, competition between previously separated industries to provide the same service. The Act thus creates unprecedented conditions for competition <u>and</u> for the concentration of ownership.

While the weight of negotiations was between the major corporate players, theirs were not the only voices. This was a public process, and the non-profit organizations, the librarians, the computer societies, the consumer groups had a real, if limited, impact in the debate. Their public interventions made the question about what constituted the public good something which the corporate players had to address.

The expectation was that erasing regulatory-imposed industrial boundaries and permitting business consolidation would lead to competition across platforms. The Telecommunications Act <u>did</u> spark much merger activity. It's nearly impossible to keep up with the rush of mergers, acquisitions, and joint ventures, the more momentous of which include the buyout of the Regional Bell Operating Company Pacific Telesis by another, SBC; the merger of two other Bell companies, Nynex with Bell Atlantic; the purchase of MCI by WorldCom. At one point there was serious talk of a merger between SBC and AT&T. Broadcasters and content-oriented companies are attempting to integrate vertically, controlling production through to distribution. But thus far the prospect of cross-platform competition appears nowhere on the horizon. In fact, what seems to be happening is that major industrial players have backed away from competition and instead have used the pro-acquisition atmosphere to consolidate their positions in their traditional bases of operations. At the same time, after agreeing to its provisions in pre-legislation negotiations, certain players have challenged the Telecommunications Act and the FCC's interpretation of it as part of a distinct legal strategy. The local telephone companies have tried to get around the FCC's baseline requirement that they open their local networks to competitive entry before they are allowed into long-distance and other competitive markets. So the problem of the power of the former monopoly or incumbent dominant provider vexes the current American communications scene and undermines the vision of competition.

V. I want to qualify the original statement about deregulation having just local political explanations. The reason for this is that the sea change in American (and British) telecommunications policy set in motion a powerful dynamic of asymmetric deregulation that created <u>exogenous</u> pressures on all other PTT systems to open up -- even in the less developed nations. This pressure was due to several factors but in short, once one key player opted out of the national monopoly model and its telecommunications system became governed by market-oriented principles, the inherent flexibility of the technology permitted the liberalized system's now entrepreneurial companies to siphon off business traffic from regulated systems. And because business and international traffic brings in the revenue that cross-subsidises other services, their loss threatened to undermine the entire traditional edifice. Traditional telecommunications enterprises found themselves in a situation of either adapting or losing crucial revenues. This more or less describes the dynamic in Europe. Through the negotiating mechanisms of the European Union, telecommunications markets have been opened up and the PTT system eroded.

In Latin America, to the limited degree I understand it, the deregulation of telecommunications took place within the larger context of the debt crisis of the 1980s. With their economies in financial bankruptcy, major Latin American countries were confronted with a choice: either sever their damaged ties with the global economy and be cut off from new loans and investment, or else accept a profound restructuring of their economies, strictly following the policies designed for each country by the IMF on behalf of the creditors. The IMF strategy essentially consisted of two main features: first, the control of inflation, particularly by sharply reducing government spending and imposing fiscal austerity; and second, privatization of as much as possible of the public sector, particularly its most profitable companies, offering them up to foreign capital bidding. Because the privatization of public sector companies -- including telecommunications -- disrupted all kinds of time-honored political alliances and distributive claims, it tended to be accomplished outside the public political process. Reform was secured by executive "diktat," acts that scholars of democracy have called typical of "delegative," or "not quite" democracies.

I want to contrast the Latin American experience with one I had the good fortune to participate in -- South Africa's. Post-apartheid South Africa faced a telecommunications structure that delivered reliable and sophisticated services to whites and to business -- only. The incumbent monopoly operator was deeply in debt, overstaffed, its management largely tied to the old apartheid order and culture, and was now expected to expand the network rapidly to the black majority. In contrast to the insulated processes of telecommunications reform in many countries, reform in South Africa was conducted within a democratizing context and was itself a democratic process of a unique participatory and deliberative kind. Over a period of less than two years, an extremely open and consultative stakeholder policy-making process resulted in a set of reasonable technical and political compromises and became legislation. Here was an instance of negotiations within civil society and between civil society and the state over the shape of a new political economy, where consensus building would have normative force for the participants.

The lessons of the South African experience are these. To be part of the global economy a country must accommodate open circuits and open markets. This is not the result of a simple "imperial" urge; it is a complex historical process shaped by economic structures and political struggle. Transforming old telecommunications systems has become essential. Though technical, the transformation of telecommunications is not and should not be a technocratic process. It should be an open political process. Only then will there emerge new social alliances that can produce new social benefits.